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TAGS: EFIN ETRD BEXP ECON EINV PGOV BR
SUBJECT: The Ever-Rising Real Part II: The Emergence of Dutch Disease?

REF: Brasilia 366

¶1. (U) This is the second of a two-part series on the macro-economic consequences of the recent rise in the Brazilian real. The first cable in the series, Brasilia 366, looked at the GOB's macro and debt management policies. This cable, authored by ConGen Sao Paulo, considers the effect of the strengthening real on the business sector.

¶2. (U) Summary. As the real reaches its highest level in five years (reftel), some economists believe the Brazilian economy may be suffering from a form of "Dutch disease," a diagnosis stoutly denied by government officials. Nonetheless, Development/Industry/Trade Minister Furlan has warned that the current exchange rate threatens exports and has called for adjustments. Export-dependent industries are increasingly concerned about their future competitiveness if the real continues to strengthen, and many are freezing or cutting back investment. Even some import-competing industries, such as textiles, are beginning to feel pressure. More ominously, some agricultural giants are feeling the pressure and are moving major production facilities to other countries. End Summary.

DUTCH DISEASE: A DIRE DIAGNOSIS

¶3. (U) Critics of Brazil's monetary policy have added a new concept to their artillery: "Dutch disease." Originally given the moniker "national resource curse," the term was coined by The Economist magazine in 1977. Dutch disease refers to the deindustrialization of a nation's economy owing to the discovery of a natural resource, the export of which raises the value of that nation's currency, thereby making manufactured goods less competitive with those of other nations, increasing imports, and decreasing exports. The phenomenon was first noticed in the Netherlands in the 1960s after the discovery of North Sea gas. In recent weeks, several prominent Brazilian economists, such as Professors Carlos Eduardo Goncalves and Joaquim Eloi de Toledo of the University of Sao Paulo, and Francisco Eduardo Pires de Souza, advisor to the Department of Planning at the state-owned National Bank for Economic and Social Development (BNDES), have argued that Brazil is suffering from Dutch

disease symptoms.

¶4. (SBU) Some analysts claim that Dutch disease has afflicted Brazil because of the rise in the country's exports of minerals and high-priced commodities like soybeans. In 2005, agribusiness accounted for nearly 86 percent of Brazil's trade surplus, which came in at a record USD 44.8 billion. Domestically, the effects of the strengthened real are already reportedly affecting industries that generate many jobs, even those that don't export (e.g., footwear and textiles) forcing factories to shut down in the face of increasing competition from Asian countries, such as China. Recent estimates claim the strong real forced nearly 1,000 companies, principally small and medium-sized enterprises, out of the export market last year. Officials at CIESP, a prominent Sao Paulo state industry federation, note that while Brazil registered record exports in 2005 - US$118 billion -- the country's export base was quite narrow: 40 companies were responsible for 45% of exports while 60 companies accounted for 65% of exports. Trade balance figures released February 19 showed that imports grew more than exports in the third week of February. The trade surplus (exports minus imports) fell from US$ 881 million in the previous week to US$ 579 million.

¶5. (SBU) Carlos Velloso, a prominent economist with links to the opposition PSDB party, argued to Econoffs that Brazil is seeing Dutch Disease-like effects due to burgeoning exports of high priced commodities. These effects, he pointed out, extended to all tradable goods sectors, including import-competing sectors such as textiles. And while low-priced Chinese textile imports were a key competitive threat for the Brazilian textile sector, he said, so was the appreciated Real.

GOB DENIALS

¶6. (SBU) Brazilian government officials are quick to dismiss the notion that the country has caught Dutch disease. In a recent press interview, BNDES President Guido Mantega said, "Dutch disease does not apply to Brazil, which faces no risk of deindustrialization, or of returning to an agro-exporter past." Mantega, a former Minister of Planning and one of the leading economists in the governing Workers' Party (PT), noted that manufactured products comprise a majority of Brazil's exports, and that "Brazilian industry has never been stronger." Mantega further observed that Brazil's share of the world market is growing and that the Brazilian car industry exported 33 percent more vehicles in 2005 than in 2004. Mantega pointed out that the automotive industry was the sector that posted the highest level of growth in the past three years, with increases in output, productivity and job creation. (Note: Many of the low-priced vehicles manufactured in Brazil are exported for sale to consumers in Mexico; in turn, Mexican producers manufacture vehicles for sale in the more lucrative U.S. market.)

¶7. (U) Minister of Development, Industry and Foreign Trade Luiz Fernando Furlan also argues that Dutch disease does not apply to Brazil, pointing out that the country can boast of a wide variety of export sectors, of which industrial products represent a large share, with no single commodity or sector dominating. Nevertheless, both Furlan and Mantega acknowledge that the continued rise in the real is worrisome. With respect to the decline in the trade surplus announced last month, Furlan publicly noted that this was the first time in recent years the trade surplus had dropped in the month of February in comparison with February of the previous year.

¶8. (SBU) Local economists are divided on the subject. Some have "diagnosed" the disease and maintain that the country has already suffered deindustrialization as a consequence. Others insist that the difficulties faced by Brazil's industrial sector are the result of overly high interest rates and taxes, combined with shortcomings in infrastructure and technology. Although most interlocutors tell EconOffs that the strong real is their main concern, all agree that Brazil's unfavorable business climate would still be a hindrance even if the real remained weak. Brazil's non-competitive business

climate is generally blamed for Brazil's failure to grow, while it is the strong real that has been blamed for actual export shrinkage.

¶9. (U) Fernando Cardim de Carvalho, a professor at the Federal University of Rio de Janeiro, believes that although the situation differs from the experience of the Netherlands, Brazil is in fact suffering the effects of currency overvaluation. In a recent interview, Carvalho argued that the overvaluation of the national currency is not an inevitable consequence of the surplus of dollars brought about by exports of products for which world market prices or export volumes have rapidly risen. He pointed out that Argentina and China have also experienced major growth in export revenues, but have maintained exchange rates favorable to exports, and low interest rates, converting their trade surpluses into currency reserves, unlike Brazil. Carvalho contended that the problem with Brazil lies with high benchmark interest rates set by the Central Bank, which make it too costly to expand reserves the way that China and other countries with large trade surpluses have done. In addition, he added, high interest rates have attracted speculative capital (as opposed to Foreign Direct Investment), which has further exacerbated the overvaluation of the real. Carvalho warned that depending on agricultural or mineral exports is "bad business, because world market prices for primary sector commodities are highly unstable." Regardless of whether Brazil is facing Dutch disease or not, economists and government officials agree that export industries are suffering from the strong real.

INDUSTRY FEELS THE PAIN

¶10. (SBU) The business newspaper Valor Economico cites a poll

conducted in the U.S. with 203 American companies operating in Brazil, which shows an abrupt change in their plans to invest here. According to the study, disappointment with poor GDP results in 2005 and the increasing valuation of the real vis-a-vis the dollar have led U.S. companies to reduce investments in Brazil. Interlocutors throughout the Sao Paulo consular district (which accounts for close to 70 percent of Brazil's GDP) have consistently complained to EconOffs that the strengthening real is hurting local industry and that the effects of the weakened dollar will be evident in 2006 first quarter reports. While most complaints have involved industrial sectors (auto, machinery, etc.), recent trends show that the strong real is starting to affect Brazil's agricultural sector as well. This is especially bad news, given that agro-business accounted for 86 percent of Brazil's 2005 record trade surplus. Although strong international prices for commodities buoyed agro-exports during the real's 2005 rally (gaining almost 17 percent), it appears that large agro-business is finally feeling the real's pinch. This is evident in the experiences of agro-business companies Bunge and Archer Daniels Midland (ADM).

Agro Agony

¶11. (U) American agro-giant Bunge, which processed 13 million tons of soy in Brazil last year, announced in February that it will have to close brand new factories that it just completed constructing in
¶2005. In December, it suspended processing at 7 of its 49 fertilizer plants, and shut down 2 of its 12 soy processing factories. Meanwhile, Bunge just finished construction on a soy plant with a capacity to process 19 million tons a year in neighboring Argentina. Bunge states that it is transferring a portion of its Brazil operations to Argentina for tax and "competitiveness" reasons. Moreover, Bunge investment in Brazil over the next four year will be cut by 70 percent. Bunge representatives remarked, "the impact of the exchange rate has become violent for our company. The only way to maintain viable operations that would still be acceptable to our shareholders was for us to reduce operations."

¶12. (SBU) But the damage is not confined to the closing of factories. Bunge representatives warned of unfolding

deindustrialization in the Brazilian agro-sector. According to Bunge, "tax difficulties, the exchange rate, and infrastructure and logistic problems are leading soy producers to gradually reduce operations." The Brazilian Association of Vegetable Oil Industries warns that while Brazilian grain exports will grow 10 percent in 2006, exports of processed products (such as soy oil and meal) will fall by four percent. Bunge claims that they already experienced this four percent decrease in 2005. Bunge's export volume for 2005 was a mammoth USD 2.2 billion, but company executives note that this high figure masks an underlying problem: high exports represent an increase in prime material (grain) and a reduction in processed goods (oil and meal). According to Bunge, "this dramatic reduction in industry is not easily reversed. Brazil is turning into a world-class provider of prime material, but it's losing industrial capacity. This is not a trend that will simply reverse itself once it's discovered."

¶13. (SBU) U.S. company Archer Daniels Midland Company (ADM), another of Brazil's principal soy producer, is experiencing the same problems as Bunge. ADM has reduced soy processing operations in Brazil by 30 percent. Factories in the southern cities of Tres Passos, Rio Grande do Sul and Paranagua (Parana state), with capacities to process 1,000 tons of soy per day, will not return to operations for the 2006-07 crop. ADM remarks, "the increasing cost of the real has provoked a loss in international competitiveness. This has forced us to refrain from investing and close down factories." Although it was in the middle of its corporate investment cycle, ADM has suspended further investment in Brazil, though the company could return to invest again if the exchange rate softened. ADM admitted, "with the current exchange rate, Brazil is not the export platform it used to be."

Auto Anguish

¶14. (SBU) The effects of the strong real are felt most acutely by businesses that produce manufactured and semi-manufactured goods, with strong dependence on low internal costs. Damiel Prates, a researcher at the Center for Political Economy at the University of Campinas, remarked, "the exchange rate is critical in the area of manufactured goods. Brazil has just started to face the realities of exchange rate politics. The figures already show that industrial exports are falling by the wayside." The irony, according to Jose Ricardo Roriz Coelho of the Federation of Industries of Sao Paulo State (FIESP), "... is that the real's 2005 increase of 16.75 percent is an effective tax break on imports, while at the same time an increased tax on exports." This export tax is being felt across industrial sectors. For example, the American company Eaton, which produces automotive power train components in Brazil, has felt the pinch. With 30 percent of its revenue tied to exports, Eaton has already received demands from clients: reduce costs or we'll seek alternative suppliers. According to Eaton's Vice President for Latin America, Carlos Alberto Briganti, "the automotive industry has already asked for a 10 percent cut in costs. The strong real limits new gains in productivity in the automotive supply chain, a sector that has not dealt with inflation for a long time." Briganti notes that Eaton's challenge isn't just maintaining contracts, but also acquiring new contracts. "The real concern is the future," says Briganti.

Strong Real: Weak Growth?

¶15. (SBU) Comment: The real concern is the future. This sentiment is prevalent among our business interlocutors. Brazil experienced less-than-mediocre GDP growth of 2.3 percent in 2005 (in the hemisphere, only Haiti performed worse). While many estimates for 2006 range between 3.5 to 4 percent, achieving this could be difficult as export industries feel the squeeze of the strong real. And, while the Dutch Disease-diagnosis seems to us to be premature, should these nascent deindustrialization trends consolidate, Brazil could lose some of the ground it has gained in industrial exports and see itself returning to its previous status as primarily an

export platform for raw materials and prime agricultural goods. The Lula administration has resorted to targeted benefits for certain export-oriented sectors in an attempt to ameliorate the effect of the appreciated Real on export industries. Given current expectations that the Real will appreciate further and remain strong into the medium term, however, the GoB may find such simple palliatives wanting. But, we have no expectation that broad-based tax reform or other necessary microeconomic reforms, which could do much to offset the effects of the exchange rate by reducing costs for businesses and increasing their competitiveness, will be addressed by the Congress at all during this presidential election year. End Comment.

¶16. (U) This cable was coordinated with Embassy Brasilia.

McMullen